JUST A LITTLE "NUDGE": CURING INVESTORS' RATIONAL APATHY

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Abstract

Corporate governance scholars have long taken for granted that retail investors do not vote their shares, and viewed the investors' apathy as a necessary evil once ownership is no longer closely held. Building on behavioral economics tools, this Article presents a novel solution that could substantially mitigate, if not fully eliminate, the long-standing problem of investors' rational apathy, with minimal regulatory burden. The solution is based on the premise that the high economic and mental costs associated with voting could be dramatically reduced by providing retail investors with a little nudge in the form of highly-visible voting default arrangements that would allow (or force) them to choose from a menu of voting short-cuts. Aside from strengthening shareholder democracy, mobilizing retail investors with different voting heuristics will have other important advantages such as providing for greater accountability of companies' incumbents.

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I. INTRODUCTION

Do you vote? Yes, of course I vote, most people would answer. Let us rephrase the question: do you vote your shares? Did you ever? Most of us, after shaking off their confusion, would say no. They may add, why should we even care? Indeed, it is no surprise to any of us who ever owned a share. Every year we get a series of envelopes/emails from our broker, we may or may not bother opening them, but shortly thereafter they will find their way to the recycling box, left untouched.

Retail investors, who individually hold small fraction of a firm's cash flow and voting rights, often lack the incentives to monitor management. Since the process of informing and expressing one's preferences is costly, retail investors often choose to refrain from any involvement in the governance of the corporation,[1] simply defer to management's agenda or relay on other active, large shareholders to do the work for them. This is the essence of rational apathy in the context of corporate law discourse and it has played an integral part in the modern U.S. corporate governance paradigm for long time.[2]

However, we should care. While individually it might make sense for shareholders to ignore their rights to express preferences regarding the governance of the firm, collectively, the absence of retail shareholders voice might allocate improper weight and power to management, or to certain large shareholders, and distort the optimal

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[1] *See, e.g.,* Broadridge & PwC ProxyPulse, '2013 Proxy Season Recap', Third Edition (2013) (noting that of shares held by individual or 'retail' investors, an average of 30% were voted at annual meetings in 2013).

[2] *See infra* notes 8-10, and accompanying text.

decision-making process.[3] In addition, recent changes to NYSE voting guidelines, which have substantially limited the ability of brokers from voting shares held on behalf of retail investors, created dead-look situations where low participation by investors prevents companies from amending their governing documents, even when the amendments are desirable to both management and shareholders.

Finally, large-scale changes to the corporate governance landscape that took place over the last two decades have further aggravated the problem of investors' rational apathy. While these recent regulatory changes, along with the increased involvement of certain activist shareholders, were aimed at a good purpose - restraining managerial entrenchment by enhancing disclosure requirement and subjecting more matters to shareholder vote - they also had an unintended consequence: increasing the costs associated with exercising an informed vote, which have further fouled the apathy shareholders suffer from.

Corporate governance scholars have long struggled to find ways to mitigate the agency problems caused by rational aphetic investors. Independent directors,[4] institutional investors[5] and activist hedge funds[6] were all championed as agents that could bridge the gap between the individual shareholder apathy and the collective good. However, they have all taken investors' rational apathy as a constant that could not change, therefore focusing on other actors and means to mitigate their lack of participation.

But why should rational apathy stay constant? Couldn't we tackle it head first, eliminating the ability of rational retail investors to remain passive? Can't we reduce the costs of participation to a level where it is no longer rational to remain passive? Indeed, first signs of a shift in the regulatory approach to retail investors' participation can be found in a

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[3] *See infra* Section II.B.

[4] *See, e.g.,* Jeffrey Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007).

[5] *See, e.g.,* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992).

[6] *See, e.g.*, Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007).

roundtable that the SEC is organizing that "will focus on strategies for increasing retail shareholder participation in the proxy process."[7]

In this Article, we propose using behavioral economic tools to solve this long-standing problem of investors' rational apathy. In particular, we propose to facilitate retail investors' participation in the voting process by providing them with a little "Nudge" in the form of highly visible default arrangements that would allow (or force) them to choose between several available voting short-cuts, such as voting along with a specific large and sophisticated shareholder, in accordance with the majority vote of intuitional investors not affiliated with management, or in accordance with the recommendation of a proxy advisor.

Imagine, that you no longer need to open that heavy envelope you received in the mail. Instead, when you sign in to your brokerage account, a pop-up window (that you may or may not be able to close) would allow you to make a number of short and simple voting choices. By hitting the right box you would instruct that your shares would be voted in the same manner as Fidelity or other large shareholder votes, with management, or based on ISS recommendation. You can always choose to opt out of all those options, and continue to make your own decision. Instead of investing the resources in making an informed decision case by case, you may now use a shortcut, indirectly choosing an agent to make the choice for you. You can bet on yourself, you may decide not to partake, but for many of us this process would be so seamless and costless that now a choice will be made.

This novel solution is based on the premise that the economic and mental costs associated with voting could be reduced dramatically by nudging retail investors with highly-visible voting default arrangements. Such nudge is likely to substantially increase retail investors' participation in the governance of the firm. Aside from strengthening shareholder democracy, mobilizing retail investors with different voting heuristics will have other important advantages such as providing for greater accountability by public companies incumbents and improving firm value.

The rest of the Article is organized as follows. Part II reviews the prevalence and the costs rational apathy poses in the context of the public firm, against the backdrop of recent changes to the corporate governance landscape. Part III explains how behavioral law and

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[7] *See* SEC PRESS RELEASE, *SEC to Hold Roundtable on Proxy Voting, (Jan. 27, 2015) http://www.sec.gov/news/pressrelease/2015-15.html#.VMqBQy5Zf_g*

economics can help in addressing this concern. Part IV presents the general framework of our solution and the design questions that must be addressed by a policy maker. Part V reviews the benefits that would stem from the adoption of such new regime. Part VI addresses potential concerns that might arise from the implementation of a nudging mechanism, and Part VII concludes.

II. THE PROBLEM OF RATIONAL APATHY

This part lays out the background to our discussion. Section A presents the main problem addressed in the Paper – retail investors' limited participation in corporate decision making – and shows that it is even of a larger magnitude nowadays. Section B explains the importance of retail investors' participation in corporate decision making by highlighting the social costs associated with their lack of participation. Section C then shows how recent regulatory and corporate governance changes that were originally aimed at strengthening shareholder voice have paradoxically exacerbated the concerns regarding low retail investors' participation in corporate governance and corporate decision making.

A. Investors' Rational Apathy and Its Magnitude

Most retail investors are rationally aphetic.[8] A diversified investor, who holds a small stake in large public company, knows that her vote probably will not affect the voting outcome, and therefore has very little incentive, if at all, to invest time and efforts in the costly process of collecting information and studying the firm's affairs in order to make an intelligent voting decision regarding the election of directors or other corporate matters. For such shareholder, it is simply economically rational to stay uninformed, and not to vote at all.[9]

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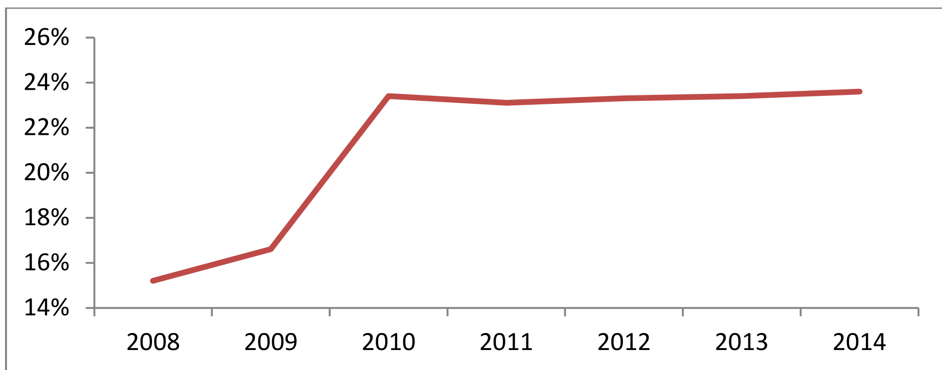
[8] *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 584-91 (1990) (discussing rational apathy, and shareholder's incentives to become informed); Christopher Gulinello, *The Retail-Investor Vote: Mobilizing Rationally Apathetic Shareholders to Preserve or Challenge the Board's Presumption of Authority*, 2010 UTAH L. REV. 547, 573-74 (2010) (discussing rational apathy of retail inevestors).

[9] *See* Black, *supra* note 8, at 584; Gulinello, *supra* note 8, at 573-74.

While investors' rational apathy, which is a natural result of the dispersion of ownership and diversification of investor portfolios, has been a long-standing problem of public firms,[10] one can rightfully wonder whether technological changes, such as the employment of the Internet to facilitate shareholder voting, have not eliminated it. The answer is negative. As evidence we present in this Part shows, the problem of rational apathy continues to exist, and it could have a substantial impact on the voting results, and, as we argue in this Paper, it may have an equally important negative impact on the incentives of certain shareholders and management.

For that end, we investigated the total percentage of shares that were not voted in each of the matters standing for a vote at S&P 500 companies in the years 2008-2014 and found two significant trends.[11] First, the percentage of shares that do not vote is very significant standing at 23.6 percent of the total votes in 2014. Second, we identify that non-participation rates have been trending up, further exacerbating the issue. Since 2008 the percentage of non-voting shares has jumped by 64 percent from 15.2 percent in 2008 to 23.6 in 2014. In Section C of this Part, we provide an explanation for this negative trend.

Figure 1: Percentage of Non-Voting Shares in S&P 500 Companies



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[10] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 66 (1991), and Black, *supra* note 8.

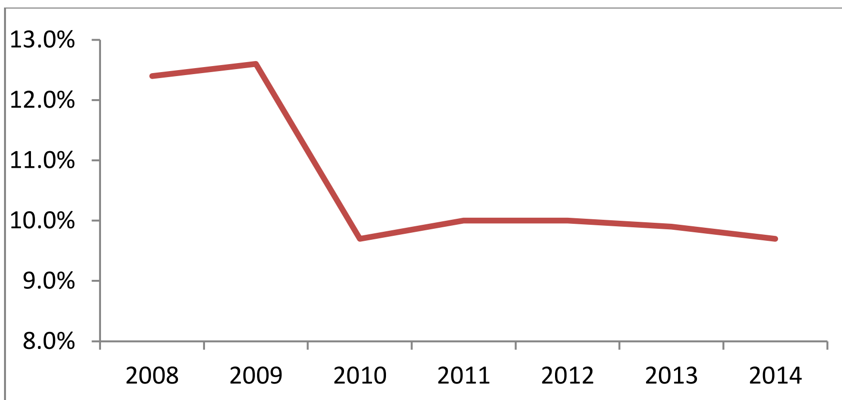
[11] Data was obtained from the Sharkrepellent database and is valid through January 15, 2015. The Sharkrepellent database contains various statistics on all public companies in the U.S., including broker non votes, votes cast and total votes outstanding for the years 2008-2014.

We further corroborate these trends with an examination of Broker Non-Votes statistics. Since around 85% of equity shares listed on stock exchanges are held by brokers in "street name" on behalf of clients,[12] an indirect additional way to roughly estimate the magnitude of investors' rational apathy is to look at the percentage of shares held by brokers, for which clients have not provided instructions as to how to vote.

For instance, in 2008, brokers who had not received instructions from their clients voted 16.5 percent of all shares voted in public corporations.[13] Similarly, a recent study found that in 2012 the average level of uninstructed broker votes was 10.4 percent of outstanding shares in director election of US Russell 3000 companies.[14]

We further confirm these findings by investigating voting percentages on all matters that were brought to a shareholder vote in the S&P 500 for the years 2008-2014. Similarly to existing studies, we find that the level of broker-non-votes has been ranging from 12.6% to 9.7% during that period.

Figure 2: Percentage of Broker Non-votes in S&P 500 Companies



[12] *See, e.g.,* Securities and Exchange Commission, Roundtable on Proxy Voting Mechanics ("Approximately 85% of exchange-traded securities are held by securities intermediaries"), May 23, 2007 (available at http://www.sec.gov/spotlight/proxyprocess/proxyvotingbrief.htm).

[13] *See* Client Alert, Wilson Sonsini Goodrich & Rosari, P.C., *SEC Eliminates Discretionary Broker Voting for Uncontested Director Elections* 2 (July 15, 2009), available at: http://www.wsgr.com/publications/pdfsearch/wsgralert_rule452_amendment.pdf

[14] *See* Scott Hirst, *Forzen Charters* (working paper, 2014), at 18-19.

Importantly, this estimation of uninstructed broker votes, which varies between 9.7%-16.5%, is just the low boundary of the number of investors who do not exercise their votes, since 15% of the equity shares listed on stock exchanges are held directly by investors (and not through brokers) and thus are not included in the above estimation. It may well be the case that some, if not most, of the investors who hold the shares in their names also avoid voting, and therefore the percentage of rational aphetic investors could be even higher than the above-mentioned range.

The combination of the significant number of broker-non-votes, and the increased prevalence of shares that do not vote, validate our concern that the problem of retail investors' rational apathy is, therefore, a one of a large magnitude even nowadays.

Moreover, as we discuss in greater length below, full participation in the election process becomes particularly important when management faces a contested election, when a withhold campaign is organized against incumbents, or when shareholder proposal to initiate an important governance change, is brought to a vote at the annual meeting. Mobilizing 10-15% of the eligible voters could have substantial impact on the final vote results of those campaigns or proposals, and could make the difference between having a shareholder initiative pass or fail.

B. The Costs of Rational Apathy

While it is economically efficient for a small, individual investor to be rational apathetic, such behavior has negative externalities on other investors that should not be ignored. When a substantial number of individual investors avoid voting, this behavior, in the aggregate, may have significant costs from the perspective of shareholders as a whole. First, the decision of a large number of shareholders not to vote may undermine the traditional allocation of power between shareholders and the board, and reduce the impact of shareholder vote as a mechanism to discipline the board. Second, low participation rates among retail investors limit the ability of shareholders to pass important governance changes. Third, such apathy may distort the voting outcomes, and this distortion, as we show, often works in favor of management, a dominant activist shareholder, or a controlling shareholder. Finally, the decision of a large number of investors to remain rationally apathetic might lead to

dead-lock situations where a governance amendment that is desirable to both management and shareholders would not pass due to low shareholder turnout.

1. Reducing Board Incentives to Remain Accountable to Shareholders

The division of labor in corporate law is very clear: Decision-making power is generally vested with the board of directors.[15] The board and the management of the corporation enjoy vast authority and discretion to operate the business of the corporation, and the law is specifically designed so that the shareholders have no direct role in the management of the corporation.[16] But, the board's power and authority is not without limits. Corporate law does provide shareholders with certain voting rights that allow shareholders, at least in theory, to keep the board accountable.[17] Those voting rights include the ability to elect and remove directors, to approve amendments to the governing documents of the corporation, and to approve fundamental transactions.[18] Shareholder-voting mechanism is, hence, an important tool that provides management with *ex-ante* incentives to remain accountable to shareholders.

While it may be economically efficient for each retail investor not to exercise its right to vote, such behavior imposes negative externalities on all other investors, since it undermines the delicate balance of powers between the board and shareholders, and weakens management *ex-ante* incentives to remain accountable. Consider the ability of shareholders to discipline board members through withholding votes from directors' nominees. This is a major way for passive shareholders to express their voice within the current regulatory framework, and to signal the board that they are dissatisfied with its action. The 2015 guidelines of the ISS, for instance, recommends that shareholders withhold their vote when board engage in problematic

[15] *See*, for instance, Delaware General Corporation law: "The business and affairs of every corporation … shall be managed by or under the direction of a board of directors … ." Del. Code Ann. tit. 8, § 141(a) (2001 & Supp. 2008).

[16] *Id.*; Gulinello, *supra* note 8, at 550-51.

[17] Gulinello, *Id.*

[18] *See, i.e.,* William A. Klein & John C. Coffee, Jr., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 123-125 (10th ed. 2007) (discussing shareholder voting rights).

practices, such as unilateral bylaw/charter amendments that materially diminish shareholder rights, problematic audit-related practices, problematic compensation practices, lack of board independence, and lack of responsiveness to shareholders and other general governance failures.[19] However, when a non-negligent number of shareholders avoid participating in the vote, the ability of shareholders to convey their dissatisfaction from the board's poor practices is impaired. The voice of shareholders is diluted, and this, in turn, reduces boards' incentives to remain accountable to shareholders. Retail investors, therefore, through their decisions not to vote at all already play an important role in undermining the balance of powers between board and shareholders.

2. Limiting Shareholders' Ability to Initiate Governance Changes

Rule 14a-8 of the Securities Exchange Act of 1934 allows a shareholder who meets certain criteria[20] to include a shareholder proposal on the company's own proxy, to be voted upon at the company annual meeting.[21] Voting on such proposal is a major way through which shareholders could initiate, and at times approve, governance changes that were not initiated or supported by management. While shareholder proposals are usually submitted in a non-binding form, they have become an important mechanism to drive governance reforms in the past decade. The number of votes in support of shareholder proposals, and in particular proposals aiming at improving firms' corporate governance, has increased dramatically since early 2000,[22] with an average shareholder support of 45.5 percent in 2013 and 2014.[23] There has also

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[19] *See*, ISS, 2015 U.S. PROXY VOTING SUMMARY GUIDELINES 38, 41 (2015), available at http://www.issgovernance.com/file/policy/2015ussummaryvotingguidelines.pdf.

[20] Those criteria include holding shares worth $2000 (or 1% of the market value of equity) for at least one year. *See* Securities Exchange Act of 1934 Rule 14a-8, 17 C.F.R. § 240.14a-8 (2007).

[21] *Id.*

[22] *See*, Stuart L. Gillian & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN. 55, 64-66 (2007) (showing voting support for corporate governance and compensation related shareholder proposals submitted in 2005 is significantly higher as compared to the support rate in 1987-1994 period); and Yonca Ertimur, Fabrizio Ferri, and Stephen R. Stubben, *Board of Directors Responsiveness To Shareholders: Evidence From Shareholder Proposals*, 16 J. CORP. FIN. 53, 57-59 (2010) (showing the percentage of governance-related proposals receiving a majority vote jumps from 18% (1997–2001) to almost 32% (2002–2004)).

[23] Shareholder proposals that attracted particularly high rate of support in 2013 and 2014 (on average) are: board declassification (81.5%); majority voting (59.5%); eliminate super majority provisions (69.5%); right to call special meeting (51%) and proxy access proposals with 3%- and 3-

been a pronounced increase in the rate of management implementation of non-binding shareholder proposals that receive majority support,[24] often due to the increased influence of proxy voting advisory firms.[25]

However, the ability of shareholders to initiate important governance changes might be restricted by the passivity of retail investors. A high shareholder support for governance changes usually increases the likelihood that the board will take steps to implement a non-binding proposal. Such high support rate could serve as a more effective pressure mechanism on management, and it could also provide tangible evidence that the proposal has real chances to clear the required voting threshold, which is at the minimum 50% of the votes outstanding, but could be even higher due to supermajority requirements. The avoidance of retail investors from voting is likely to reduce the number of votes in favor of the suggested governance changes, especially for those proposals that traditionally receive strong support from institutional investors and that retail investors could be expected to support as well if they were to participate in the vote. Rational apathy, therefore, impairs the ability of shareholders to initiate important governance changes.

3. Distorting Vote Outcome

Low retail investors' participation in corporate decision making could also distort the voting outcome. The distortion is created if the voting choices of shareholders who decide not to vote are different from the exercised votes. This distortion could work in different directions, which we discuss below:

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year thresholds (44%-65%). *See*, Sullivan & Cromwell LLP memorandum, *2014 Proxy Season Review* (Jun. 25, 2014), available at, http://www.sullcrom.com/siteFiles/Publications/SC_Publication_2014_Proxy_Season_Review.pdf.

[24] Renneboog and Szilagyi, for instance, show that rate of implementation of passed proposals grew dramatically from 17.1 percent between 1996 and 2000, to 23.6% in 2002 and 70.1% in 2005. *See* Luc Renneboog & Peter G. Szilagyi, *The Role of Shareholder Proposals in Corporate Governance*, 17 J. CORP. FIN. 167, 173-75 (2011).

[25] For instance, when management ignores shareholder proposals that receive majority support, proxy advisory firms are likely to recommend against votes on individual directors or the entire board at future annual meetings. *See*, Sullivan & Cromwell LLP memorandum, *supra* note 23, at 22-23.

(i) *Distortion in Favor of Management*. A distortion in favor of management occurs when shareholders who did not participate in the election were expected to vote against management in a higher proportion than shareholders who participated in the vote. There are two factors that, in our view, could increase the likelihood of a vote distortion to work in favor of management. First, broker discretionary voting along with brokers' tendency to vote with management is likely to distort the voting results in favor of management in certain situations. NYSE rule 452 allows brokers who had not received instructions from its clients to vote the uninstructed shares based on their discretion, if the proposal for shareholder vote is on a "routine" matter.[26] Evidence shows that brokers overwhelmingly vote in the manner recommended by management,[27] and that broker discretionary voting used to constitute a non-negligent number of all shares voted in public corporations.[28] Although the ability of brokers to exercise a discretionary voting has been significantly narrowed in recent years,[29] it has not been fully eliminated,[30] and there has been a call for broadening it once again.[31]

Second, management exclusive power over the proxy process, especially in uncontested situations, could further distort the voting

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[26] *See* Eliminate Broker Discretionary Voting, Exchange Act Release No. 34-60,215, 74 Fed. Reg. 33,293, 33,293-95 (July 1, 2009) (describing the history and the basic processes of broker discretionary voting).

[27] *See* the Report and Recommendations of the Proxy Working Group to the New York Stock Exchange, June 5, 2006, at 14; Jennifer Bethel & Stuart Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, 31 FIN. MGMT. 29 (2002); Gulinello, *supra* note 8 at 564.

[28] In 2008, for instance, 16.5% of the brokers had not received instructions from their clients. *See* Wilson Sonsini Goodrich & Rosari, P.C., *SEC Eliminates Discretionary Broker Voting for Uncontested Director Elections* 2 (July 15, 2009), available at http://www.wsgr.com/publications/pdfsearch/wsgralert_rule452_amendment.pdf.

[29] *See, i.e.,* Information Memo 12-4, which imposed new limits on the practice of broker discretionary voting by no longer treating corporate governance matters as 'routine' for the purposes of Rule 452. In addition, an earlier amendment to rule 452 from 2009 made director voting in uncontested elections a non-routine matter. *See*, Eliminate Broker Discretionary Voting, Exchange Act Release No. 34-60,215, 74 Fed. Reg. 33,293, 33,293-95 (July 1, 2009).

[30] For instance, one matter that does appear to remain subject to broker discretionary voting is the ratification of auditors. See Alston and Bird LLP Memorandum, *Update – NYSE Expands Range of "Broker May Not Vote" Matters Under Rule 452* (January 26, 2012), available at http://www.alston.com/files/publication/8ae6c210-a58e-440c-bc1f-f708d54381cc/presentation/publicationattachment/d9c9d9e1-8c45-41d4-82a8-1d0980505116/12-055%20nyse%20information%20memo.pdf).

[31] *See, e.g.* Hirst, *supra* note 14, at 39-40. For additional critic of Information Memo 12-4, see Alston and Bird LLP and Bird Memorandum, *id*.; Paul Hastings Memorandum, *NYSE Implements New Restrictions on Broker Discretionary Voting*, (March 2012), available at http://www.paulhastings.com/assets/publications/2136.pdf.

results. Management exercises significant power over the design and content of the proxy materials, the agenda of the meetings, as well as the dissemination of the proxy information. It is likely that through its vast control over the content of proxy materials and the voting process in general, management does as much as it can to mobilize retail investors to vote in favor of management.

A striking example from past years was the use of "Vote with Management" option by most proxy distribution service providers and transfer agents, which gave a stockholder the opportunity to vote, with one click of a button, in accordance with the recommendations of management.[32] This practice which was subsequently abounded after the SEC expressed concerns over its impartiality,[33] served as a form of a voting nudge, but only in favor of management. This further suggests that the investors who choose to remain aphetic despite management's different nudges would be more likely to vote against management if they participated in the election.

(ii) *Distortion in Favor of other Activist/Dominant Shareholders*. Vote distortion could also be in favor of an activist shareholder who advocates for a change in the business or financial strategy of the corporation that is not supported by all other investors. Activist shareholders often launch, or threaten to launch, a proxy fight against the company to exercise additional pressure on management to accept their view. If retail investors who decide not to participate in the vote were more likely to vote against the nominees of a dominant shareholder because their interests are aligned with those of institutional shareholders who oppose the activist shareholder proposals, then their decision not to vote distorts the vote result in favor of the dominant holder.

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[32] *See* Ross Kerber, *Proxy sites dump one-click vote button on SEC concerns*, March 20, 2013, publicly available at http://www.cnbc.com/id/100574479.

[33] In 2012, the staff of the SEC announced new interpretive guidance under Rule 14a-4 and Rule 14a-2(a)(1) under the proxy rules that impacted the "Vote With Management" button. Under the new guidance, the staff expressed the view that the presentation of a "Vote With Management" button without the presentation of a corresponding "Vote Against Management" button was inconsistent with the plain language of Rule 14a-4 and the "impartiality" requirement of Rule 14a-2(a)(1). This guidance was announced publicly by Tom Kim, the Chief Counsel of the SEC's Division of Corporation Finance, at the Annual SEC Speaks Conference in Washington D.C. in February 2013. Following the new guidance, Computershare, one of the largest transfer agents, and Broadridge, which acts as the agent for most brokers and banks, eliminated the "Vote With Management" option for the 2013 proxy season. *Id.*

Similar distortions could be created when the company has a controlling shareholder who holds less than 50 percent the voting rights, but still exercises an effective control over the firm by holding a substantial fraction of firm's voting rights. In such cases, investors' rational apathy further facilitates the controller's effective control, and corporate decisions that benefit the controllers, but harm other shareholders, are less likely to be blocked. This is because the controller will vote its entire stake in favor of its initiative, and the avoidance of rational apathetic investors from voting will make it harder for other institutional investors, who oppose the controller's proposal, to obtain the requisite vote in order to block such proposal. This low (and sometime extremely low) chance to block a controller's proposal could, in turn, provide retail investors with *ex-ante* negative incentives to not participate in the vote, causing the rational aphetic problem to be particularly severe in controlled companies.

In sum, in all of these situations, mobilizing retail investors to cast a vote will reduce the potential distortions in the voting outcome due to retail investors' low participation. These distortions work first and foremost against the rest of the shareholder base that does participate in the vote but faces lower chances to block detrimental governance changes due to the problem of rational apathy.

4. Creating Deadlock Situations

Retail investors' rational apathy and their limited participation in corporate decision making could also lead to deadlock situations caused by the inability of shareholders who choose to participate in the voting process to comply with the quorum or threshold requirement for approving certain governance changes. These deadlock situations are particularly troubling when both management and the shareholders who participate in the vote are interested in the same outcome for a matter that is brought to a shareholder vote. But, they are unable to achieve this outcome because the vote is subject to special approval requirements that are a percentage of shares outstanding (such as special supermajority requirement or an approval of majority of minority shareholders), and the vote fails to receive such required threshold due to a low shareholder turnout. Therefore, although an outcome is desirable *for both* management and shareholders, the parties are unable to pass it due to investors' rational apathy.

One major example for a deadlock situation is the case of "frozen charters". A recent study shows that a non-negligent number of charter amendments, that by rule have to be initiated by management, have failed since 2012 despite receiving over 90% shareholder support.[34] The study also estimates that there are hundreds U.S. public corporations that are unable to amend their charter due to the combination of low shareholder turnout and approval requirements that are a percentage of shares outstanding. The problem of deadlock situations created by rational apathetic investors is therefore an acute one.

C. The Rise of the Shareholder Franchise and its Unintended Effect on Rational Apathy

The public outcry regarding excessive executive compensation in the late 1990's, the corporate scandals of the early 2000's and the aftermath of the financial crisis in 2008 have all led to an increased regulatory intervention aimed at providing additional information and monitoring rights to shareholders. In particular, those regulatory changes enhanced disclosure requirements and the input given, and expected of, shareholders regarding different corporate affairs by subjecting more issues to a shareholder vote.[35] In addition, shareholders themselves have become more involved in the governance of the public firms by submitting a larger number of proposals, and through the emergence of activist hedge funds that have raised the volume of contested elections.[36]

While these changes were aimed at restraining managerial entrenchment, they also had an unintended consequence: increasing the costs associated with exercising an informed vote, and thus aggravating the problem of investors' rational apathy. In this Section, we discuss these changes and their unintended impact on retail investors. Specifically we classify the impact these regulatory reforms, and the other changes that have taken place in the last two decades into three main categories:

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[34] Hirst, *supra* note 14, at 19.

[35] *See infra* notes 37-45.

[36] *See infra* notes 46-49.

1. <u>The Regulatory and Other Changes to The Corporate Landscape</u>

(i) *More information.* Disclosure requirements have dramatically intensified during the past 20 years, causing proxy statements to become substantially longer. This new atmosphere has also increased the scope of additional voluntary disclosure by companies.[37] The regulatory and market changes over the last decade have also led to an added complexity and sheer volume to financial and other reporting.[38]As a result, in today's proxy statements investors are required to review significantly larger volume of complex materials before making a decision regarding their vote.

(ii) More Input Requested. A related yet different aspect of the changing landscape in corporate governance is the greater power and input given, and expected of, shareholders regarding different corporate affairs.

In the past decade there has been a pivotal shift in corporate governance thinking toward a "shareholder franchise" approach.[39] As part of this move toward a shareholder centric model, where the firm's end is to maximize the return to its shareholders, a natural step was to contemplate means of empowering shareholders vis-à-vis management. The shareholder franchise movement has embraced this notion, calling to break down some of the barriers limiting shareholder intervention in corporate governance, in order to limit managerial slack and lead to more efficient corporations.[40] Among those barriers are the legal and proxy rules regarding board elections and shareholders' resolutions.[41]

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[37] *See* Alicia Davis Evans, *A Requiem for the Retail Investor?* 95 VA L. REV. 1047 (2009) (noting the increase in voluntary disclosure by companies).

[38] *See infra* notes 80-81 and accompanying text.

[39] *See, e.g.,* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA L. REV. 675 (2007).

[40] Professor Bebchuk, who is the main proponent of this apporahc, has published several papers advocating this change. *See Bebchuk supra note 7; Lucian A. Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 83; Lucian A. Bebchuk Response to increasing shareholder power: reply: letting shareholders set the rules, 119 Harv. L. Rev. 1784. See also* Amicus Brief of Harvard Law School Faculty submitted to the 2d Circuit in the case of AFSCME vs. AIG (along with other HLS professors), available at http://www.law.harvard.edu/faculty/bebchuk/pdfs /Amicus%20Brief.pdf.

[41] Under the current legal regime a shareholder launching a proxy fight has to incur all costs, shareholders cannot nominate board nominees on the company ballot and their resolutions are

Indeed, recent years have seen some successes on behalf of such movements. The SEC has adopted in 2010 a reform to its proxy rules that eases the ability of shareholders to voice their opinion and elect board members.[42] And while the reform was partly repealed by a federal court, current rules still require companies in certain circumstances to include in their proxy materials shareholder proposals regarding director nomination procedures.[43] In addition, Congress has passed an extensive bill that, to some extent, furthers the impact shareholders would have on the governance of the corporation.[44] The adoption of a say-on-pay rule, which requires U.S. public companies to conduct an advisory shareholder vote on executive compensation proposals, has been at the forefront of these changes.[45]

The greater input that is requested from shareholders is driven not only by regulatory requirements directly subjecting more matters to shareholder vote, but also from the indirect spill-off effect of those regulatory changes that more readily allow interested shareholders to ask

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precatory in most cases. *See* Bebchuk, *supra* note 39, at 688-694; see also Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43-66; Melvin Eisenberg, *Access to the Corporate Proxy Machine*, 83 HARV. L. REV. 1489; Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations and Poison Pills*, 3 BERKELEY BUS. L.J. 205 (Fall 2005); William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 40, 459.

[42] The final rules adopted by the SEC comprise of two main rules: (1) Rule 14a-11, which would require a publicly-traded company to include in its proxy materials a candidate nominated by shareholders that have held shares representing at least 3 percent of the voting power of the company's stock for the past 3 years; and (2) amendments to Rule 14a-8(i)(8), which would require companies in certain circumstances to include in their proxy materials shareholder proposals regarding director nomination procedures. The proxy reform mentioned in (1) passed by the S.E.C. in 2010, but was later partly repealed by a D.C. federal court. See http://www.sec.gov/rules/final/2010/33-9136.pdf Also *See* SEC press release from August 25th available at http://www.sec.gov/ news/press/2010/2010-155.htm and federal decision No. 10-1305 available at http://www.cadc.uscourts.gov/internet/opinions.nsf/ 89BE4D084BA5EBDA852578D5004FBBBE/$file/10-1305-1320103.pdf.

[43] *Id.*

[44] Dodd-Frank Wall Street Reform and Consumer Protection Act H.R.4173. In addition the bill requires that the S.E.C will set some rules in regard to executive compensation and shareholder ratification of such compensation ("say on pay"). In addition, the bill regulates sophisticated financial players and thus potentially limits their incentives and tools for activism. For a review of the main provisions of the act see: http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_ Street_Reform_comprehensive_summary_Final.pdf.; David A. Skeel Jr. "The New Financial Deal: Understanding the Dodd-Frank Act and its (Unintended) Consequences" U of Penn, Inst for Law & Econ Research Paper No. 10-21. For a critical review of the act see Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 Minn. L. Rev. 1779 (2010).

[45] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010).

their fellow shareholders to vote on various corporate governance matters.[46] As noted earlier, the number of shareholder proposals brought to a vote has increased dramatically in the past decade, allowing voting shareholders to subscribe their views on greater number of corporate matters at each annual meeting. In addition to the plethora of non-binding matters shareholders need to decide on,[47] shareholders are now more often requested to cast a binding vote as management has been responding to this surge in shareholder proposal by submitting its own resolutions.[48] Finally, the higher rates of contested director elections,[49] staged by activist hedge funds, have similarly engulfed shareholders with solicitation materials by both management and the activist.

(iii) Broader Portfolios. Retail equity holdings increased by 50% from 2010 to 2014,[50] and most retail investors nowadays hold larger sets of companies than in the past.[51] Even if all other things are held equal, the fact that many retail investors now have larger portfolios, means that shareholders are not only tasked to make an informed choice on various and growing number of matters at any given company, but that they are also required to make these choices for a growing number of companies.

2. <u>The Unintended Impact on Retail Investors' Apathy</u>

While the abovementioned changes were aimed to increase shareholder power vis-à-vis management, and while they exemplify the importance of having shareholders more involved in corporate matters in

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[46] *See supra* notes 22-24.

[47] *See e.g. infra* notes 53-54 and accompanying text.

[48] For a review of all management proposals submitted in 2014, *see* Georgeson, *2014 Corporate Governance Review*, 44-54 (Oct. 23, 2014), available at http://www.computershare-na.com/sharedweb/georgeson/acgr/acgr2014.pdf.

[49] There were 152 cases in 2012 They have increased 31% over the same period in 2011 where 116 such campaigns were announced *see* John Lovallo, *Proxy Contests on the Rise – Activists Emboldened by Success*, LEVICK DAILY (Oct. 28, 2013), http://levick.com/blog/2013/10/28/proxy-contests-rise-%E2%80%93-activists-emboldened-success

[50] *See* table L.213 of the Federal Flow of Funds Accounts Release, *Financial Accounts of the United States,* FEDERAL RESERVE STATISTICAL RELEASE (December 11, 2014) http://www.federalreserve.gov/releases/z1/current/z1.pdf; *see* also Jawad M. Addoum, *Household Portfolio Choice and Retirement*. (working paper, 2014) (documenting the increasing importance of retail investment as in 2011 they directly held stocks valued at $8.1 trillion who make up an important fraction of equity holdings in the US).

[51] *See* Brad M. Barber and Terrance Odean, *The behavior of individual investors*, 2 HANDBOOK OF THE ECONOMICS OF FINANCE 1533 (2011) (citing the proportion invested in one company stock has declined over the past 10 years).

order to make the board more accountable, they at the same time had an unintended result. They created a chilling effect on participation by retail investors.

Paradoxically, the additional control rights that are now allocated to shareholders also increase the costs associated with exercising a vote, leading retail investors to opt-out from the voting process altogether. The longer proxy statements become, the lower the chances that retail investors will actually read them. Similarly, individual investors now have to spend more time and efforts on collecting information and making informed votes on a growing number of matters, and this, in turn, reduces the chances that rational aphetic investors will exercise any vote at all.[52] The apathy shareholders suffer from has, therefore, been further fouled by these large scale shifts in the corporate governance landscape.

Consider for instance the example of Apple. In 1994, the company proxy statement had 18 pages, and only two proposals were submitted to shareholder votes.[53] Twenty years later, the company proxy statement was more than five times longer. It held 90 pages (including appendixes), and 11 different proposals were brought to shareholder vote.[54]

Since many investors tend to diversify their portfolio, they hold stocks in numerous companies. Therefore, each proxy season, a retail investor who is interested in exercising an informed vote has to read hundreds of disclosure pages, and to vote on dozens of proposals regarding different matters. This information overload and the need to exercise so many votes during one single proxy season could simply be overwhelming for an individual investor, and she may give up on voting all together. To manage these large quantities of information and shareholder proposals, ordinary investors need effective heuristic

[52] *See* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets,* 95 VIRGINIA LAW REVIEW 1047 (2009)(describing the behavioral findings that when faced with complex numerous options the bias towards indecision and the status quo is more pronounced).

[53] *See* Apple Inc., Proxy Statement (Form DEF 14A), (Dec. 12, 1994).

[54] *See* Apple Inc., Proxy Statement (Form DEF 14A), (Feb. 28, 2014).

shortcuts,[55] and this is where our proposed solution, of default short-cuts, comes into play.

To be clear, the view presented in this Section is not that those recent regulatory changes or the increased shareholder involvement in corporate governance is unwarranted. To the contrary, we believe that such changes, on average, promote shareholder value by keeping management more accountable to shareholders. We do, however, highlight the negative spill-over impact of these changes on the problem of rational apathy, and argue that these effects should not be ignored. We particularly call on regulators to consider adopting effective voting shortcuts along the lines presented in this Paper, which would mobilize retail investors to vote, thus bridging between the expectation and benefits of shareholder involvement and rational investor's apathy.

III. BEHAVIORAL ECONOMICS AND RATIONAL APATHY

Behavioral law and economics (BLE) has been broadly regarded in recent years as one of the most promising developments in public policymaking.[56] Surprisingly, despite the broad implications of BLE to many fields, including retirement savings, consumer credit, health issues, and environmental protection,[57] its implication to corporate governance remains at the margin of the BLE discourse. This Part discusses the rise of behavioral economics and its different uses in the legal field. In particular, we focus on the concepts of bounded rationality and on nudging tools that BLE scholars advocate for, and that, in our view, could prove to be extremely beneficial in encouraging retail investors to vote.

A. The Emergence of the Behavioral Law and Economics Movement

The BLE movement has been attracting a lot of attention in recent years, as an increasing number of studies systematically

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[55] *See* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 7 n.26 (2003)

[56] For a review, *see e.g.,* Ryan Bubb and Richard Pildes, *How behavioral economics trims its sails and why*, forthcoming 127 HARV. L. REV. (2014).

[57] *Id*.

documented the numerous ways that human behavior differs from the rational behavior assumed by neoclassical economics.[58] In particular, BLE literature documented that rationality is bounded. Brain and time limitations lead rational people to adopt rules of thumb as a way to economize on cognitive faculties,[59] leading in turn to mistakes in judgment and perception. By incorporating more realistic models of human behavior based on these findings, the emerging field of BLE strives to modify some of the regulatory and policy recommendations that were based on the neoclassical model, with regulatory and policy measures that better account for the deviations of actors from the rational path.[60]

Two of these modifications are particularly relevant for the purpose of our discussion. First, the replacement of the rational actor assumption with the more precise behavioral assumption has lead the behavioral scholars to suggest that a whole new breed of market failures exists, one that stems from the actors irrationality, rather than from lack of information or competitiveness. For instance lack of appropriate retirement savings due to cognitive errors and self-control problems is often mentioned as a behavioral market failure.

Second, since the actions of actors might deviate from what a rational theory might predict, BLE calls for reconsideration of the regulatory tools that are currently employed by regulators. Most importantly, the behavioral approach challenges the limited toolbox that

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[58] For a review, *see e.g.,* Ryan Bubb and Richard Pildes, *supra* note 56; Sendhil Mullainathan & Richard Thaler, *Behavioral Economics*, in INTERNATIONAL ENCYCLOPEDIA OF THE SOCIAL & BEHAVIORAL SCIENCES 1094–1100 (Neil J. Smelser and Paul B. Baltes eds., 2001). *See also* Matthew Rabin, *Psychology and Economics*, 36 J. ECON. LITERATURE 11 (1998) (surveying the evidence of departures from the neoclassical rational actor assumption).

[59] Christine Jolls, Cass R. Sunstein, and Richard Thaler, *A behavioral approach to law and economics*, 50 STAN. L. REV. 1471 (1998).

[60] In the US the main advocate of using BLE in regulatory and policy making is Prof. Cass Sunstien. *See* Cass R. Sunstein, SIMPLER 100–26 (2013); Courtney Subramanian, *'Nudge' Back in Fashion at White House*, TIME.COM (2013), http://swampland.time.com/2013/08/09/nudge-back-in-fashion-at-white-house/. In The UK similar efforts have been spurring *see* RHYS JONES ET AL., CHANGING BEHAVIOURS:ON THE RISE OF THE PSYCHOLOGICAL STATE 23(2013). Similar initiative has been adopted in the EU as a whole *see* EUROPEAN COMMISSION, APPLYING BEHAVIOURAL SCIENCES TO EUPOLICY-MAKING (2013), available at http://ec.europa.eu/dgs/health_consumer/information_sources/docs/30092013_jrc_scientific_policy_report_en.pdf.; as well as the OECD ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, CONSUMER POLICY TOOLKIT, available at http://www.oecd.org/sti/consumerpolicy/consumerpolicytoolkit.htm

the neoclassical theory availed itself. Instead of only using rational carrots and sticks, regulators may now use an array of other regulatory tools that the neoclassical theory could not accept. Default rules, for instance, should not matter under a rational economics-theory scenario but have been proven to matter in significant ways in the real-world setting.

While not without its critics,[61] the mainstream of the BLE movement has strived to bridge and reconcile the neoclassical model with the behavioral findings, rather than completely abandon it.[62] Several prominent scholars have advocated the use of regulatory means, often termed as "soft paternalism" that maintain the ability of rational actors to choose, while improving the likely choice of those who decide not to choose or act irrationally. Professors Sunstein and Thaler have formally coined this as a "Nudge":[63] the use of modest regulatory means such as disclosure and default rules as a way to nudge people in the right way while maintaining their ability to opt-out if they wish to. Focusing on opt-out defaults and soft paternalism, the Nudge school of thought preserved the neoclassical model of rationality, by allowing rational actors to act against the nudge if they wish to.[64]

B. The Implications of Behavioral Law and Economics for Corporate Governance

One of the early fields challenged by the BLE movement was the field of corporate finance and particularly the Efficient Market Hypothesis[65] that stands at the epicenter of modern corporate finance discourse. Providing, sharp, testable predictions about observable phenomena and high-quality data available to test these sharp

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[61] *See* Ryan Bubb and Richard Pildes, *supra* note 51, *see also, e.g.*, Tom Baker & Peter Siegelman, *Protecting Consumers from Add-On Insurance Products: New Lessons for Insurance Regulation from Behavioral Economics*, Unpublished manuscript(2013); Paul Heidhues & Botond Kőszegi, *Exploiting Naïvete About Self-Control in the Credit Market*, 100 AM. ECON. REV. 2279 (2010).

[62] *See* Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism"*, 151 U. PA. L. REV. 1211 (2003); Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159 (2003).

[63] *See* Richard H. Thaler & Cass R. Sunstein, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH,AND HAPPINESS (2008).

[64] *See, e.g.*, BEHAVIORAL LAW & ECONOMICS (Cass R. Sunstein ed., 2000).

[65] *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN.383 (1970)(providing a survey of theoretical implications of efficient markets and empirical testing of the efficient markets hypothesis). *See also* Donald C. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992).

predictions, the efficient market hypotheses[66] was the perfect petri dish for the BLE movement to substantiate its claims.[67] Similarly, many BLE studies probed closely related financial aspects such as savings[68] and investment decisions.[69] While corporate finance and related consumer aspects were heavily investigated by the BLE, corporate governance, and in particular, shareholder participation in corporate elections did not receive similar attention. A number of studies used the BLE approach to criticize the SEC regulation,[70] or to examine issues such as IPO's,[71]

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[66] *See* Donald Langevoort, *Taming the Animal Spirits of the Stock Market: A Behavioral Approach to Securities Regulation*, BERKELEY PROGRAM IN LAW & ECONOMICS (2002) (stating that one important characteristic of the financial markets is that they generate extensive data and that because of this transparency, behavioral finance is somewhat better positioned to test for the real world impact of bias in market prices than research in more opaque economic settings). *See also*, Richard Posner, *Rational Choice, Behavioral Economics and the Law*, 50 STAN. L. REV. 1551 (1998); Jennifer Arlen, *The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765 (1998).

[67] The efficient markets theory has been attacked from multiple fronts, behavioral and others, For an extensive literature review, *see* Stephen F. LeRoy, *Efficient Capital Markets and Martingales*, 27 J. ECON. LIT. 1583 (1989); Robert J. Shiller, MARKET VOLATILITY (1989); Lawrence Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 GEO. WASH. L. REV. 546 (1994); Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance.* Clarendon Lectures. Oxford (Oxford University Press, 2000); John Y. Campbell, *Asset Pricing at the Millenium*, 55 J. FIN. 1515 (2000); Daniel Kahneman & Mark Riepe, *Aspects of Investor Psychology*, 24 J. PORTFOLIO MGT. 52 (1998). In addition to the finance studies there are also laboratory studies that seek to replicate features of the financial markets. *See, e.g.,* Ananda Ganguly et al., *Do Asset Market Prices Reflect Traders' Judgment Biases?* 20 J. RISK & UNCERT. 219 (2000). But see Alon Brav & J.B. Heaton, *Competing Theories of Financial Anomalies*, REV. FIN. STUD. (2001)(observing that the differences between what behavioral theories predict and what models based on rationality but incomplete information predict are small).

[68] *See e.g.*, James Banks, Richard Blundell and Sarah Tanner, *Is There a Retirement-Savings Puzzle?* 88 AMERICAN ECONOMIC REVIEW 769 (1998); Brigitte C. Madrian and Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 QUARTERLY JOURNAL OF ECONOMICS, 1149 (2000); Ted O'Donoghue and Matthew Rabin, *Procrastination in Preparing for Retirement*, in BEHAVIORAL DIMENSIONS OF RETIREMENT ECONOMICS (Henry Aaron, ed. Washington, D.C.: Brookings Institution, 1999); Richard H. Thaler and Shlomo Benartzi, *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving*, 112 JOURNAL OF POLITICAL ECONOMY 164 (2004).

[69] *See e.g.*, Charles M. C. Lee, Andrei Shleifer and Richard H. Thaler, *Investor Sentiment and the Closed-End Fund Puzzle*, 46 JOURNAL OF FINANCE, 75 (1991); Terrance Odean, *Are Investors Reluctant to Realize Their Losses?* 53 JOURNAL OF FINANCE, 1775 (1998); Hersh Shefrin & Meir Statman, *The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence*, JOURNAL OF FINANCE 777 (1985); Nicholas Barberis et al., *Prospect Theory and Asset Prices*, 66 Q. J. ECON. 1 (2001). *See also* Nicholas Barberis & Ming Huang, *Mental Accounting, Loss Aversion and Individual Stock Returns*, 56 JOURNAL OF FINANCE 1247 (2001).

[70] *See* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC,* 56 STAN. L. REV. 42 (2003) (noting that "[o]ne response.., would be to ignore investors' behavioral biases altogether and structure regulation on the basis of the rational actor model" but also noting that "[w]e think that is an unlikely outcome"); Donald Langevoort, *supra* note 66.

auditors' work[72] or the dissemination of information to investors,[73] but generally speaking the application of BLE to main-stream corporate governance discourse remains at the margin of the BLE discourse.

In particular, BLE literature that directly deals with the exercise of shareholder rights, including the participation in corporate elections, has been very limited. One study has focused on minority shareholder protection in the context of closely held companies.[74] Another study, which is the closet to this Paper's agenda, has focused on providing retail investors with more information as a means to increase their participation.[75] However, as we contend, the suggestion to provide more information to investors suffers from the same issues that lead to investor's apathy to begin with.

This lack of attention of BLE scholars to corporate governance and retail investor participation in governance of the corporation is puzzling. As we discussed above, against the backdrop of the board-centric model of the U.S. public firm and the recent shareholder franchise movement and reforms, the rational apathy observed by retail investors has been both significant in magnitude as well as increasingly important, and therefore could be an important research area for behavioral economists.

Looking at retail investors' "rational apathy" through a behavioral economics lenses reveals that such apathy could stem not only from their unbounded rationality (i.e. when the actor has limitless resources but the costs of participation exceed it benefits), but also due to their bounded rationality (i.e. when investors' inability to deal with large quantities of information precludes any vote even if the costs of participation do not exceed its benefits). More importantly, using BLE, and in particular some of the nudging tools it advocates for, could prove to be extremely beneficial in reducing the costs of participation to retail investors, thus making an impact both under an unbounded or bounded rational apathy assumptions. It would nudge retail investors to overcome

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[71] *See* Stephen J. Choi, *Behavioral Economics And The Regulation Of Public Offerings*, 10 LEWIS & CLARK L. REV. 85 (2006).

[72] *See* A. C Pritchard, *The Irrational Auditor and Irrational Liability,* 10 LEWIS & CLARK L. REV. 19 (2006).

[73] *See* Jill E. Fisch, *Regulatory Responses to Investor Irrationality: The Case of the Research Analyst*, 10 LEWIS & CLARK L. REV. 57 (2006).

[74] *See* Judd F. Sneirson, *Soft Paternalism For Close Corporations: Helping Shareholders Help Themselves,* WISCONSIN LAW REVIEW

[75] *See* Gulinello, *supra* note 8.

their bounded rationality, without interfering with an unbounded rational decision to remain apathetic. It will also reduce the costs of participation to an unbounded investor, increasing the likelihood of participation.

Understating that the behavioral law and economics tool-kit could be useful in limiting investors' rational apathy is just the first step. The next question one must ask is what type of voting heuristics or short-cuts regulators could provide retail investors in order to increase their participation in the voting process. In the next Part, we dissect this exact question and put forward a general framework as to how voting nudges could serve as a means to increase shareholder participation in corporate decision making.

IV. POTENTIAL SOLUTIONS

In this Part we present two potential BLE-type solutions to the long-standing retail investors' rational apathy problem. The first solution focuses on facilitating retail investors' participation by redesigning the current voting default arrangements to provide shareholders with voting heuristics or short-cuts that would nudge investors to make a choice, and that would substantially reduce the costs of voting. The second solution focuses on providing shareholders with an additional simplified disclosure form for unsophisticated/retail investors. For several reasons discussed in this Part, we believe that the first solution is preferable and has the potential to significantly limit, if not fully eliminate, the problem of investor rational apathy while maintaining the ability of all investors to make their own informed choice.

A. Redesigning the Voting Mechanism to Facilitate Shareholder Participation

In this Section we call for redesigning the voting system in a manner that would shift the default choice of rational aphetic shareholders from non-participation to participation. Specifically, we suggest the adoption of a simple mechanism providing retail investors with default choices ("short-cuts") that would allow them to align their

vote with other shareholders/proxy advisors whom they deem to have similar interests.

Importantly, by allowing shareholders to make a choice not regarding any specific issue at hand but rather regarding the best agent to make an informed decision on their behalf, we significantly increase shareholder involvement without imposing substantial costs on the company or the market, while also dramatically reducing the costs of participation to retail investors themselves. At its essence, our proposed solution is similar to a situation where an investor delegates the voting authority to a money manager by investing through an intermediate entity (i.e., a pension fund) rather than directly holding the company's shares. Thus, our proposed solution provides retail investors with some of the benefits that investing through an actively-managed fund brings to the table (decision making regarding optimal vote), but without the costs associated with it (e.g. management fees).[76]

Choice Architecture Design: while the idea of using voting heuristics is very intuitive, the design of such voting shortcut system is far from simple, and involves different choices and considerations that regulators will have to take into account. Below we provide what we identify as several levels of design choice that a policy maker would need to consider before adopting such regime.

(i) Voting Options. The first design consideration revolves around the nature of the shortcuts offered to shareholders. One option is to provide retail investors with a list of large shareholders with whom they might want to align their interests, and to allow them to request *ex-ante* to tag-along with one of these investors. A second option is to allow shareholders to vote according to the recommendations of proxy advisors. In recent years the scope and coverage of proxy advisors recommendations has substantially grown so that every issue coming to a vote carries with it a proxy advisor recommendations. A third option would focus on joining the majority of the shareholders on each specific point (with or without including management/controlling shareholder shares), shifting the emphasis from a specific actors vote to the

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[76] *See, e.g.*, John C. Coffee, *The SEC and The Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837 (1994); Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, *in* THE NEW PALGRAVE DICTIONARY OF ECON. AND THE LAW 459 (Peter Newman ed., 1998).

consensuses of shareholders. Finally, the policy maker would need to consider whether to provide an option to not participate all together by "choosing not to choose" (an opt-out), potentially removing the need to provide such investor with a voting nudge in future occasions.

(ii) An Opt-out or Opt-in Regime? Equally germane to the effectiveness of the proposed mechanism is the question of what type of initial default would be put in place. If an opt-in regime is chosen, then shareholders would be left with the current system as a starting point but would be offered the opportunity to enroll into these additional set of shortcuts. Importantly, they would have to make an active choice in order to exercise their vote according to a short-cut, thus potentially leading to a lower participation rate compares to an opt-out regime.[77]

Under an opt-out regime shareholders would be forced to choose a shortcut when making the initial investing decision (when buying shares with a broker), requiring them to opt-out, either initially (for instance by providing a full opt-out option in the short cut selection phase), or on an ad-hoc basis, deviating from their pre-assigned designation by submitting a detailed vote when needed.

The choice between opt-in and opt-out regimes also reflects the regulator views regarding the main issue that prevents retail investor's participation. If retail investors' participation is mainly driven by bounded rationality, then an opt-out regime would be better suited (since the cost of decision making is not the main driving force behind the apathy). However, if unbounded rationality is the pivotal concern then an opt-in regime might be better suited (since investors are more likely to recognize their need for short-cuts).

(iii) Increasing Options' Visibility. Increasing the visibility of the voting mechanism is another key issue. Currently, shareholders have the ability to simply ignore voting materials or voting requests without incurring any costs, and this, in turn, has further contributed to their incentives to remain apathetic. By increasing the visibility of the

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[77] Investors are less likely to participate for a combination of reasons such as inertia, lack of knowledge, lack of interest, procrastination and others. *See e.g.* James J. Choi, David Laibson, Brigitte C. Madrian, and Andrew Metrick, *Optimal defaults*, AMERICAN ECONOMIC REVIEW (2003); Brigitte C. Madrian and Dennis F. Shea, *The power of suggestion: Inertia in 401 (k) participation and savings behavior*, THE QUARTERLY JOURNAL OF ECONOMICS (2001).

potential choices and shortcuts, and by increasing the costs of ignoring these options, retail investors are more likely to make voting decision. For instance, brokers may design a pop-up screen when a retail investor logs into her account, forcing her to check a box with a decision regarding the desired short-cut before proceeding to manage her account. A similar approach can be conducted with paper accounts, requiring new customers to provide a choice when opening a broker account.

(iv) The Duration and Scope of Shareholder Choice. When adopting a default-choice regime, a related question that would need to be addressed at the choice-design stage is the question of the duration and scope of a shareholder choice. A default mechanism could be implemented in various forms and for different durations. For instance, shareholders could have a different shortcut for each of the questions that are brought for a shareholder vote. Alternatively, they could have one shortcut for all issues raised at a specific shareholder meeting and such shortcut could also be applicable for more than one meeting, potentially until modified. Similarly, the choice may be valid to all of the companies in the investor's portfolio, or be applied on a company by company basis. Designing duration and scope would ultimately reflect the policy maker's opinion on the right balance between achieving participation at "all costs" on the one hand and achieving informed participation on the other hand. Allowing the default arrangement to last for a longer duration reduces the costs of participation for retail investors, but it may also lead to choices that retail investors might not prefer in the long run as their initial shortcut selections might no longer represent their current preferences.

(v) Allowing for Variance between Companies. So far we have adopted a "one size fits all" approach whereby all issuers will be required to implement the same voting shortcuts. A more nuanced approach could suggest that regulators allow for variance and differentiation between companies. Instead of a standard unified arrangement, different issuers will be allowed (or required) to present different shortcuts, if at all, based on the severity of the rational apathy problem in those companies. For instance, regulators could impose the voting shortcut requirements only on companies where retail investor's lack of participation has been more pronounced or could play a more significant role (e.g. controlled companies, high super majority, stocks

from smaller indexes). For instance, in 2013 broker non-votes have accounted for 24 percent of the votes outstanding in Bank of America but for less of 0.1 percentage points at Hess Corporation.[78]

B. More Is Not Necessarily Better - Simplifying Disclosure Requirements

While the focus of many regulators and scholars has been on providing investors with more disclosures and information,[79] we believe that such focus has been misguided in the context of retail investors. We suggest that the overload of information is an important factor contributing to retail investors' rational apathy and thus advocate for an approach that would simplify the information provided to investors in a manner that would reduce the costs of making a choice.

As noted above, one of the major issues that drive retail investors out of the voting game is the vast amount of information provided to them. Even if an investor were interested in casting a vote, the amount of information in the proxy materials is so large that apathy is indeed rational under those circumstances. Reducing the overflow of information, therefore, may help increasing retail investors' input.

Since fully detailed company disclosures are important for other, more sophisticated shareholders, and since it may carry internal benefits for the company, our proposed route seeks to maintain the current system in place while adding a more user-friendly version of the disclosure documents intended for retail investors.

Particularly, the proposed disclosure regime would require companies to provide shareholders with two types of disclosure documents. The first would be the existing document, providing a comprehensive set of data and analysis. The second would be a new mandatory "short form" disclosure that would contain only the germane information pertaining to the issues on which shareholders input is directly requested.

1. Design

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[78] *See supra* note 11 and accompanying text.

[79] *See* Gulinello *supra* note 8.

While the exact design of a short-form document is a matter of a nuanced and detailed process, below we highlight a few of the main design aspects that should be considered:

(i) Conciseness. Since the main function of the short-form is the reduction in data volume, it is germane that the form would be as concise as possible. Among the potential design questions that would need to be evaluated are whether each short form should be capped in length by an absolute number or as a ratio of the full proxy statement; whether the company can maintain the same language as used in the original proxy but remove parts of it or whether the language should also be modified to enable the provision of more data in less space.

(ii) Unity. As noted, part of the issue with current proxy statements is that they are, intentionally or not, poorly designed. While each company is obligated to include similar data in its proxy, the order and design of each proxy vary considerably between companies. The lack of unity leads to an additional costs of time and effort when reviewing more than one proxy. To mitigate this factor, short-form proxy should follow the same structure, thus easing the ability of shareholders to review them more effortlessly.

(iii) Order. Similarly, the placement of the items in the short-form proxy should be done in a manner that would maximize investors' attention span. For instance, it might be beneficial to start with all matters going to a vote, prior to the sections regarding financial results and other data.

2. Benefits and Costs

The benefits of this approach are two folded: First, it provides retail investors with better sensitivity regarding their costs of obtaining information, prior to casting a vote. Investors could choose to stay non-informed, they could choose to be informed on the important matters at an intermediate level that requires minimum costs by using the short-form proxy, or they could choose to be fully informed (potentially doing so after first obtaining the intermediate level of information). Second, the

benefits[80] of the current disclosure regime would remain intact: sophisticated investors would still enjoy the full set of information required to accurately reflect the price of the share – assuring that share price would continue to reflect the value of the firm as accurately as possible – and the company would still have to produce the full set of information, enhancing the chances that internal processes would prevent misstatements and fraud.[81]

However, this route also suffers from several shortcomings. First, it would increase the costs the corporation has to bear. The corporation would now be required to create two sets of disclosure documents, and those documents would have to conform to the SEC requirements. As such, the costs to the corporation in complying with this augmented disclosure regime would rise[82] and these costs ultimately would be borne by all shareholders if the corporation chooses to remain public, and might be further exacerbated if such requirement would encourage corporations to go private or discourage private corporations from going public.

Second, in order to provide a short-form document that is effective and concise, companies would have to exclude certain relevant information that could, ironically, lead shareholders to make uninformed decisions, force them to revert back to apathy or to expend resources in order to make informed decisions. Consider the issue of say-on-pay for instance. Current proxy materials have a bounty of information about pay structure, incentives, design and so on. By minimizing the amount of information, some relevant data would be forced out, thus leaving

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[80] While we choose to hold the current regime as constant, many have criticized the regulatory regime's costs. *See e.g.* Roberta Romano, *The Sarbanes-Oxley Act and the making of quack corporate governance*, YALE LAW JOURNAL 1521 (2005); Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2010); William J. Carney, *Costs of Being Public after Sarbanes-Oxley: The Irony of Going Private*, 55 EMORY L. J. 141 (2006); Peter Iliev, *The effect of SOX Section 404: Costs, earnings quality, and stock prices*, 65 THE J. OF FIN. 1163 (2010).

[81] *See, e.g.*, Cheryl L. Wade, *Sarbanes-Oxley Five Years Later: Will Criticism of SOX Undermine Its Benefits*, 39 LOY. U. CHI. LJ 595 (2007); Mark H. Lang and Russell J. Lundholm, *Corporate disclosure policy and analyst behavior*, *ACCOUNTING REVIEW* 467 (1996); David S. Gelb and Paul Zarowin, *Corporate disclosure policy and the informativeness of stock prices*, 7 REVIEW OF ACCOUNTING STUD. 33 (2002); Jonathan R. Macey, *Efficient capital markets, corporate disclosure, and Enron*, 89 CORNELL L. REV. 394 (2003); Larry E. Ribstein, *Market vs. regulatory responses to corporate fraud: A critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. (2002).

[82] *See supra* note 80 and accompanying text regarding the concerns voiced regarding the current costs of being public.

shareholders with the incomplete information to make their voting choice. Assuming the investors identify that the information is incomplete, they could decide to vote based on the incomplete information and thus may make a suboptimal choice; they may, but are unlikely to, decide to revert to the full proxy materials to review the matter in detail while incurring costs they were unwilling to bear to begin with[83]; or most likely, it would lead those investors to revert back to their rational apathy.[84] A similarly inefficient result would occur if an investor does not realize that the short-form is lacking in germane information, thus again making a suboptimal choice.

Third, and relatedly, some of the major issues requiring shareholder input are so complex that they cannot easily be reduced, processed and simplified into a short-form disclosure document for unsophisticated investors. For certain issues there are simply no shortcuts in terms of the scope of the data that needs to be analyzed, and shareholders would have to review the full, raw, data to truly make an informed decision. As such, the short form may direct investors to the full materials or omit the topic altogether. In any event leading to the issues highlighted above. Even if such reductions were feasible, providing shareholders with prescreened information might lead to a loss of context, and may negatively affect the decision-making process, especially when understating the entirety of the issues at stake and the interconnection between them is important to the overall result.

Forth, since the overarching agency concern in the United States is of managerial entrenchment, leaving the design and the content of the short form disclosure at the hands of the management of the company would possibly push shareholder to vote in a manner that is tilted towards management's preferences, at the expenses of shareholders as a whole. While, the regulatory framework could alleviate some of these concerns in mandating the design of the short form as discussed above, it is unlikely to provide a comprehensive solution due to the complexity and differentiation between each corporation, which would require some discretion to be left with management.

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[83] One can argue that the short-form could serve as a behavioral trapping device. I.e. luring the investor in with the short form and once some costs are sunk, making him expand resources he would otherwise avoid.

[84] Since this is a repeating game, even if investors spend time on the first short form proxy they may soon opt-out to not participate in future votes if they conclude they have insufficient information.

C. *Tailoring the Solution to Regulators' Needs*

While nudging through the redesign of voting options is, in our view, the preferable solution for curing the problem of rational apathy, we believe the decision regarding the chosen arrangement should be left in the hands of regulators. As a general matter, a less paternalistic arrangement (such as an opt-in arrangement, a short-form disclosure, or a combination of the two) is likely to have a reduced positive impact on shareholders' participation level. Whereas a more paternalistic arrangement (such as an opt-out arrangement that forces all shareholders to make a choice) is likely to significantly reduce, if not totally eliminate, the problem of rational apathy. While one solution can be more effective, but also more paternalistic, than the other, we still believe that adopting our proposed framework, in one form or another, will already be a value-creating move. We now turn to discuss the advantages of the proposed framework.

V. ADVANTAGES

Increasing retail investors' participation would carry with it a number of advantages for all parties involved. Those advantages as well as the solution's ease of feasibility will be highlighted in this Part. Section A shows that the proposed solution will be helpful in solving dead-lock situations where an amendment that is desirable to both management and shareholders could not pass due to low shareholder turnout. Section B analyzes the impact of the proposed solution on the parties' incentives. As shown, the implementation of the proposed solution will provide the parties with *ex-ante* incentives to be more efficient and to make their value-increasing behavior more transparent to voting shareholders. Section C suggests that our proposed solution could counter-balance management exclusive power over the proxy process. Finally, Section D explores another important advantage of the proposed solution: its high feasibility of implementation.

A. Eliminating Dead-lock Situations

This Section refers to a situation where both management and shareholders are interested in achieving the same outcome for a matter that is brought to a shareholder vote. Such vote may be subject to special approval requirements that are conditioned on the achievement of a certain percentage of the shares outstanding (such as special supermajority requirement, or an approval of majority of minority shareholders). However, due to a low shareholder turnout, caused be shareholder rational apathy, the vote may still fail to receive the required approval, even if most shareholders support it. Therefore, although an outcome is desirable for both management and shareholders, the parties may be unable to achieve it due to investors' rational apathy.

One major example for a deadlock situation is the case of "frozen charters" that we described above.[85] According to a recent study, hundreds U.S. public corporations are unable to amend their charter due to the combination of low shareholder turnout and approval requirements that are a percentage of shares outstanding.[86] Since our proposed solution is likely to increase shareholder participation, it would reduce, if not eliminate altogether, this dead-lock situation.

Importantly, while other solutions addressing the problem, such as proportional voting of uninstructed shares or broker discretionary voting,[87] focus on artificially offsetting retail investors' apathy, our solution does not disenfranchise voting rights from shareholders. Broker discretionary voting, for instance, leaves the voting decisions in the hands of brokers, and thereby distorts shareholder will, as evidence shows that brokers vote overwhelmingly in the manner recommended by management.[88] Proportional voting divides the votes of the uninstructed shares in accordance with the votes of the other shareholders of the corporation. While this solution may reduce potential distortion, it does not fully eliminate them, since rational apathetic shareholders could have voted their shares differently from the proportion of the voted shared.

Our solution tackles the corporate deadlock problem from a different perspective, and instead of interfering with shareholder will, or artificially offsetting it, it simply makes it less costly and more

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[85] *See* Hirst, *supra* note 14.

[86] *Id.*, at 27-28.

[87] For a discussion regarding those proposed solutions, *see Id*., at 38-46.

[88] *See* the Report and Recommendations of the Proxy Working Group to the New York Stock Exchange, June 5, 2006, at 14; Bethel & Gillan, *supra* note 27.

convenient for retail investors to participate in corporate decision making.

B. Positive Impact on Parties' Incentives

While eliminating the deadlock problem is one of the more obvious benefits of our approach, it is not the only important one. The nudge we propose of voting shortcuts has another important purpose. It incentivizes the different parties to be more efficient and to make sure that their value-increasing behavior will be more transparent to voting shareholders. This positive impact on corporate governance and firm value will is discussed in this Section.

1. Enhancing Transparency and Efficient Shareholder Involvement

Higher retail investors' participation is likely to provide certain shareholders and management with *ex-ante* incentives to disseminate more information to shareholders, to bring about efficient changes and to block inefficient ones, benefiting all shareholders.

Under the proposed arrangement, both shareholders and management will have increased incentive to obtain and produce information in a simplified way to retail investors, so that they will be able to digest it quickly and exercise a vote in favor of the party that produces such information. Even if one believes that retail investors are unlikely to rely on this additional information, and they will simply follow the voting patterns of leading institutional investors, then management and activists will have an increased incentive to conduct additional engagements and discussions with these leading institutional investors. In any event, the proposed solution is likely to enhance transparency and the flow of information to shareholders, improving the governance playing field altogether.

Additionally, the decision of a shareholder to engage with a company and to bring about a value-increasing change depends first and foremost on its ability to receive the necessary support from other

shareholders unaffiliated with management.[89] When the percentage of shareholders who participate in the vote is relatively low due to investors' rational apathy, activists may encounter difficulties to compete with the voting block organized by management in a proxy contest situation, or to have a shareholder proposal passed by receiving a majority support of shareholder participating in the vote, or by meeting a higher threshold if supermajority requirement exists.[90] Therefore, with increased retail investors' participation value-enhancing changes are more likely to be adopted, and value-decreasing changes are more likely to be tabled or rejected.

Higher retail participation could therefore increase the chance of an activist campaign to succeed, and reduce the likelihood of value-enhancing change to be blocked by management just because there are not enough shareholders participating in the vote. This, in turn, would provide activist shareholders with *ex-ante* incentives to become more involved in the corporate matters. Since there is compelling empirical evidence showing that hedge fund activism enhances shareholder value both in the short and long term[91] and that institutional activism also serves as an important disciplinary force,[92] the increased retail investors'

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[89] For a comprehensive analysis, *see* Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. Corp. L. 51, 61-68 (2011-2012). Those costs, which in the context of hedge fund activism are related to the identification of potential targets, the financing of its equity position, and the communication with the target, could be particularly high.

[90] Consider, for instance, an example where the proposal needs 50% of the votes to pass, management controls 10% of the votes, and 15% of the investors avoid voting. In such a case, only 75% of the shareholders not affiliated with management would vote on the proposal (100-10-15), and the activist needs to solicit almost 67% of the votes (50/75) in order to have a proposal passed by a simple majority. If there is supermajority requirement of 75% of the votes, the activist will have to solicit all of the votes in order to have the proposal passed.

[91] For evidence showing that interventions by activist hedge funds are accompanied by positive stock market reactions around the filing of a Schedule 13D, *see, i.e.,* April Klein and Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN., 187, 207-211, 225-226 (2009); Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1755-57 (2008); and Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists,* 14 J. CORP. FIN. 323, 328-333 (2008); for evidence showing the long-term benefits of hedge fund activism, see Lucian Bebchuk, Alon Brav, and Wei Jiang, *The Long-Term Effects of Hedge Fund Activism* 114 COLUM. L. REV. (forthcoming, 2014).

[92] *See, i.e.,* Yonca Ertimur, Fabrizio Ferri, and Stephen R. Stubben, *Board of Directors Responsiveness To Shareholders: Evidence From Shareholder Proposals*, 16 J. CORP. FIN. 53 (2010) (showing that the implementation of a proposal that receives majority support is associated with approximately a one-fifth reduction in both the probability of director turnover and the probability of losing other directorships); Bonnie G. Buchanan, Jeffry M. Netter, Annette B. Poulsen and Tina Yang, *Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom*, 49 AM. BUS. L.J. 739 (2012) (reporting that firms targeted by shareholder proposals

participation in corporate election could further facilitate such activity to the benefit of all shareholders.

But that is only one side of the equation. If the change that an activist shareholder tries to advance decreases the value of the corporation, then such activist investor will encounter greater difficulties to bring about this change even when management is unable to block it.

Obtaining a larger number of votes could become a difficult task in the event that the proposed change does not benefit all shareholders, and the activist shareholder will be less likely to receive the necessary support for its course of action. Compare that to a case when fewer shareholders participate in the election process and thus the activist would need fewer votes to succeed (note that in many corporate decisions the required majority is calculated out of votes cast and not votes outstanding). Higher investors' participation is, therefore, likely to reduce the chances of a value-decreasing changes to be adopted.

Finally, having more incidents of value-increasing activism as a result of higher retail investors' participation will also have a positive impact on the incentives of management. If management is more concerned regarding the likelihood of activist campaigns and the chances of a proponent to win, management will *ex-ante* try to avoid such campaign altogether by taking steps to increase shareholder value. In these cases, higher retail investors' participation would indirectly serve as an additional disciplinary force, benefiting all shareholders.

2. Alleviating Distortions Caused by an Effective Controller

Engaging retail investors could also alleviate some of the distortions of incentives that are created when a controlling shareholder exercises an effective control over a company while holding less than 50 percent of the equity rights of such company.

A controlling shareholder often holds less (and sometime substantially less) than 50 percent the voting rights[93] in order to diversify

are more likely to replace their CEOs and separate the CEO and Chairman positions, and that shareholder proposals submitted between 2000 to 2006 are followed by positive stock returns).

[93] *See, i.e.*, Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FINANC. STUD. 1377, 1382 (2009) (using a sample of 375 U.S. public corporations and finding that the average size of the largest block is 26%), and Ronald Anderson, Augustine Duru & David M. Reeb, *Founders, Heirs, and Corporate Opacity in the U.S.*, 92 J. FINANCE. ECON. 205, 207 (2008) (showing

its holdings, reduce its idiosyncratic risk, and due to the need to raise new capital.[94] But, going below the 50-percent threshold does not preclude such controller from exercising an effective control over corporate affairs, and investors' rational apathy further facilitates such effective control and aggravates the distortion of incentives associates with it. An effective control may create a distortion of incentives since controllers who hold less (and sometime substantially less) than 50 percent of the equity rights bear only a fraction of the negative effects of their actions on the firm's cash flow, but they can capture the full private benefits of their action.[95]

To see the effect of rational apathy on controller's ability to exercise its effective control, consider the following example: a controller exercises an effective control by holding only 30 percent of the firm's voting rights. Suppose further that the shareholder proposal, to which the controller opposes, is brought to a shareholder vote, that such proposal needs a simple majority to pass, and that 15 percent of the investors are rational apathetic and avoid voting. In such a case, the proposal has to receive the support of more than 90 percent of the shareholders not affiliated with the controller in order to pass.[96] If, however, the problem of rational apathy were eliminated, then the proposal would need only the support of approximately 70 percent of shareholders unaffiliated with the controller to pass.

Our proposed solution, therefore, could encourage the participation of all investors in the voting process, and an effective controller, who holds less than 50 percent of the voting right, will be less

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that in 2,000 largest industrial U.S. firms, founder-controlled firms constitute 22.3% and heir-controlled firms comprise 25.3%, with average equity stakes of approximately 18% and 22%, respectively).

[94] *See, i.e.*, George W. Dent, Jr., *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725, 749 (1986); Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VIR. L. REV. 807, 812 (1987).

[95] *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 89 (2004) (explaining that asymmetric positions can produce substantial inefficiencies and may lead to expansion decision that is value decreasing for other shareholders); see also, Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-class Firms in the United States*, 23(3) REV. FIN. STUD. 1051 (2010) (evidencing that control enhancing structures, which lead to a wedge between ownership and control rights, are associated with increased agency costs).

[96] The public float after excluding the controller's stake and the shares held by shareholders who do not exercise their vote is 55%. Since the proposal has to receive at least 50.1 percent of the votes in order to pass, it will need the support of more than 90% of the shareholders not affiliated with the controller (50.1/55=91.09).

likely to block decisions or proxy solicitations that benefit other public shareholders.

C. Counter-balancing Management Exclusive Power over the Proxy Process

So far, we have assumed that institutional investors will not be the only beneficiary of our proposed solution, and that retail investors' will not always blindly follow the voting choices of dominant institutional investors without spending even a few minutes to quickly examine the issues at stake. But, even if the implementation of our proposed solution would lead to a bias in the exercise of retail investors vote toward institutional investors, we do not believe this is necessarily a negative outcome.

Management currently exercises fairly strong control over shareholder participation by controlling the dissemination of information, determining the design of the proxy materials, the agenda of the meetings, and the content of some of the issues brought to shareholder vote, and having the ability to exclude shareholder proposals from the ballot. Management also exercises significant control over the nomination of directors, unless there is a contested election. Therefore, designing a voting arrangement for retail investors that would empower major institutional investors would seem to provide beneficial counter balance to the tight control that management currently exercises over the proxy process.[97]

Moreover, even if retail investors are going to blindly follow the voting choices of dominant institutional investors, this does not necessarily mean that they will end up categorically voting against management. When management makes value-enhancing proposals then sophisticated institutional investors who can devote time and resources to closely examine the issue at stake are likely to support management proposals, and rational aphetic retail investors who blindly follow other dominant institutional investors will simply do the same.

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[97] *See* 17 C.F.R. § 240.14a-8; *see* also Gulinello, *supra* note 8, at 557-560 (discussing incumbent board control's over the company's proxy mechanism, and recent amendments to Rule 14a-8).

D. Feasibility of Implementation

The proposed solution of a nudge to retail investors' voting habits has one additional major advantage: It should be easy to implement. First, the proposed solution would impose minimal costs on issuers or broker-dealers. The solution does not require companies to exert special efforts; nor does it involve substantial costs or time commitment. All that issuers or broker-dealers will be required to do is to add a selection window with the different voting shortcuts.

Second, and more importantly, it entails minimal regulatory intervention with shareholder will. The proposed solution does not impose on shareholders a mandatory, regulatory, solution to any specific issue that is brought to a shareholder vote. While the proposed solution would provide shareholders with convenient voting "shortcuts", regulators adopting it would not interfere with shareholder freedom to choose the option that seems the most beneficial to them. In other words, the suggested choice architecture does not replace shareholder voice with the regulator's voice. It merely focuses on facilitating greater involvement of shareholders by reducing the associated costs of such involvement and by "forcing" shareholders to make any voting choice (including abstaining). Importantly, our suggested nudge does not seek to modify shareholders specific views regarding the issues brought to their vote; we only strive to modify their level of participation.

VI. POTENTIAL OBJECTIONS

This Part considers and responds to a wide range of possible objections to our suggested proposal to facilitate retail investors' participation by redesigning the voting arrangements, and providing shareholder with voting "short-cuts". We show that the objections presented in this Part do not provide a good basis for rejecting our proposed solution.

A. Interfering with Shareholder Freedom not to Choose

Even if the suggested solution is minimal in its effort to force a specific type of choice, one may argue that it does strive to force shareholders to vote, and therefore impedes their freedom to remain

totally passive, or to "choose not to choose".[98] When shareholders choose not to choose, forcing them to vote counts as a form of paternalism. Such insistence on active choosing, the argument goes on, may reduce shareholders' welfare and impede their ability to exercise their autonomy.[99]

This argument, however, could not preclude the use of *any* type of nudge to retail investors' voting habits. To begin with, the design of a nudge could maintain the freedom not to choose[100] by adding an easy opt-out or an abstain option, or by designing the voting nudge as an opt-in mechanics. Assume, for instance, the more paternalistic case where the vote nudge is designed as a pop-up window that requires shareholders to make an active choice between different voting options, such pop-up window could also include a check-the-box option which allows the investor to eliminate the use of any voting nudge in the future,[101] or to abstain from a specific vote (but keep the voting nudge in the future).

Alternatively, the voting nudge could be designed in a way that does not force shareholders to make an active choice. When a pop-up window appears shareholders who are interested in exercising their vote could easily opt into a shortcut with their preferred voting arrangement, but those who are interested in remaining rational apathetic could simply close the pop-up window.

Each of the above-mentioned arrangements will provide shareholders who (freely) choose not to choose with the ability not to choose (or at least it will minimally interfere with this right), while still ensuring that all other shareholders who wish to choose may be better served. Compared to other alternative solutions to the problem of

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[98] For an elaborated discussion on this topic, *see* Cass R. Sunstein, *Choosing Not to Choose,* (Harvard Public Law Working Paper, 2014), *available at* http://ssrn.com.ezp-prod1.hul.harvard.edu/abstract=2377364.

[99] *Id.*, at 13 (noting that those who reject paternalism typically invoke welfare, autonomy, or both).

[100] *See* Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not An Oxymoron*, 70 U. CHI. L. REV. 1159 (2003) (arguing that some kind of paternalism is newly justified, especially if it preserves freedom of choice, as captured in the idea of "libertarian paternalism").

[101] *See* Sunstein, *Choosing Not to Choose*, *supra* note 98, at 4. The ability to opt out of the voting short-cuts is similar to a situation where company asking people whether they want to choose the privacy settings on their computer, or instead rely on the default. Sunstein argues that if people are asked whether they want to choose, and can opt out of active choosing in favor of a default rule, this could be especially attractive form of libertarian paternalism.

investors' rational apathy, such as mandatory requirement to vote, the proposed solution minimally infringes, it at all, on shareholder freedom not to choose.

Second, it should be noted that even under the current voting regime, shareholder ability to choose not to vote is somewhat impaired due to broker discretionary voting on certain matters if shareholders choose to remain apathetic. NYSE Rule 452 permits brokers to vote on "routine matters" when the beneficial owner of the stock fails to provide specific voting instructions to the broker prior to a scheduled meeting.[102] Although the ability of brokers to exercise a discretionary voting has been narrowed in recent years,[103] it has not been fully eliminated.[104] Moreover, recently there has been a call to broaden brokers discretionary voting once again in order to solve problems related to the lack of shareholder participation,[105] and this suggestion if implemented will constitute a more severe intervention in investors' right not to choose than the Article's proposed solution.

B. Distracting Management

Another concern that the proposal may raise relates to distraction in management activity caused by the allocation of more voting power to institutional investors. Having a default arrangement that encourages retail investors to follow the voting patterns of large institutional investors will *de facto* lead to a dramatic increase in the voting power of institutional investors since rational apathetic retail investors are unlikely to divert from such default arrangement. This, in turn, could distract management activity as institutional shareholders will be able to use their

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[102] Rule 452 however prohibit the use of discretionary voting on non-routine matters, and the supplementary materials to the Rule lists 21 matters on which brokers are not permitted to vote discretionarily, including contested proposals, proposals relating to mergers, proposals for the election of directors, etc.

[103] *See, i.e.,* Information Memo 12-4, which imposed new limits on the practice of broker discretionary voting by no longer treating corporate governance matters as 'routine' for the purposes of Rule 452. In addition, an earlier amendment to rule 452 from 2009 made director voting in uncontested elections a non-routine matter. See, See Eliminate Broker Discretionary Voting, Exchange Act Release No. 34-60,215, 74 Fed. Reg. 33,293, 33,293-95 (July 1, 2009).

[104] For instance, one matter that does appear to remain subject to broker discretionary voting is the ratification of auditors (*see* http://www.alston.com/files/publication/8ae6c210-a58e-440c-bc1f-f708d54381cc/presentation/publicationattachment/d9c9d9e1-8c45-41d4-82a8-1d0980505116/12-055%20nyse%20information%20memo.pdf).

[105] *See, e.g.* Hirst, *supra* note 14, at 39-40.

increased power to block management initiative or to have greater involvement in corporate affairs. Relatedly, it could be argued that the this *de facto* delegation of voting power to institutional investors would not even benefit retail investors, as institutional investors often suffer from inadequate incentives,[106] and lack the necessary resources or knowledge to fully investigate complex issues brought to a shareholder vote. This institutional incompetency is also reflected by the tendency of some of them to blindly follow the advice of proxy advisory firms.[107]

This argument is also not very persuasive. First, the nudge could, and in our view should, be designed in a symmetric way so that it will provide shareholders with the ability to choose to vote not only with institutional investors but also with management as well. A symmetric voting nudge would ensure that the vote of retail investors will not necessarily be exercised only in favor of institutional investors. In fact, such nudge would provide management and institutional investors with equal access to retail investors' vote.

Also, one should remember that even under the current state-of-affairs the ability of management to manage the corporation is often disrupted by investors' rational apathy. As noted earlier, there are cases, as in the example of frozen charters,[108] where shareholder passivity and their rational decision not to vote is the main cause behind management's inability to act. Therefore our proposed solution could increase, rather than limit, management ability to act when actions initiated by management benefit all shareholders.

Finally, even if retail investors will have a tendency to vote with institutional investors, we do not believe this could truly undermine the traditional allocation of powers between management and investors. As described above,[109] management already exercises significant control

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[106] *See, e.g.*, Kahan & Rock, *supra* note 6, at 1048–57.

[107] *See, e.g.,* John D. England, *Say-on-pay Soul Searching Required at Proxy Advisory Firms*, PAY GOVERNANCE (Jun. 20, 2012), http://paygovernance.com/say-on-pay-soul-searching-required-at-proxy-advisory-firms/; (noting that "a negative ISS recommendation results in average support of 65% versus 95% for those with a positive ISS recommendation"); and Randall S. Thomas & Christoph Van der Elst, *The International Scope of Say-on-pay* 4 (Vanderbilt Law and Economics Research Paper No. 13-22, 2013), *available at* http://ssrn.com/abstract=2307510) (noting that proxy advisors' recommendations carry very substantial weight with their institutional clients, and can dramatically change the outcome of a vote).

[108] *See* Hirst, *supra* note 14.

[109] *See supra* Section V.C.

over the voting process. Management controls the agenda of the meetings, the content of the proxy material and the nomination of directors (unless there is a contested slate). Management also has the ability to exclude shareholder proposals from the ballot. Balancing such extensive control and powers with increased participation by shareholders could be beneficial in order to improve corporate governance by facilitating shareholder democracy, even if it were to impose some moderate constrains on management ability to act.

C. Encouraging Excess Shareholder Involvement

It could also be argued that greater participation of retail investors would encourage excessive level of shareholder involvement in corporate affairs due to the higher chances of shareholder led initiatives to succeed. Such excessive level of shareholder involvement in corporate matters, as may be reflected by an increased number of shareholder proposals or proxy fights, could disrupt management ability to manage the corporation without interference. The excessive level of shareholder involvement could also make it more difficult for other shareholders to identify beneficial proposals by increasing the noisiness around shareholder activity. As a result, uniformed retail investors could also support proposals that are not beneficial to the corporation.

But, if the current level of shareholder engagement with companies is not as high as it should be, then incentivizing activist shareholders to further engage with companies, could actually bring us to closer to the optimal level of shareholder involvement. True, at the end of the day, the question whether shareholder engagement is excessive or too low is an empirical one and an answer to it should be based on data and evidence. While answering this question is well beyond the scope of this Article, it is important to note that empirical evidence shows that contested elections are actually very rare. For instance, the number of contested elections that took place in each year during the period 2011-2014, varies from 35 to 45 contested events per year.[110]

Likewise, the proposed solution is expected to positively impact the submission of proposals that traditionally receive strong shareholder support, such as governance related proposals,[111] while shareholder

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[110] *See* the Georgeson report, *supra* note 48, at 56.

[111] For instance, shareholder proposals that attracted particularly high rate of support in 2013 and 2014 (on average) are: board declassification (81.5%); majority voting (59.5%); eliminate super

proposals that generally receive low support will have no chances to pass even if all the votes of retail investors were counted in favor of those proposals, and therefore the proposed solution is unlikely to increase their number.

Data on corporate governance proposals voted on at S&P 1500 companies during 2011-2014 shows that this type of activity is extremely limited. The number of governance-related proposals that were actually voted on each year varies from 240 to 269; that is, on average, less than 0.16 governance proposal per company, per year.[112]

Finally, even if the level of initial engagements will spike, sophisticated shareholders would be able to identify engagements that are destructive to the company and retail investors who will follow the sophisticated ones are unlikely to support them. This, in turn, would reduce shareholder incentives to submit inefficient proposals in the first place.

D. Encouraging Self-interested Behavior by Dominant Investors

One could also argue that providing a "shortcut" to retail investors by piggybacking their votes on those of a specific institutional investor, hedge fund or other dominant investor might create adverse incentives to such dominant investor by augmenting its voting power and creating a separation between the large investor's voting rights and cash flow rights. This, in turn, could lead to a distortion of incentives and self-interested behavior. Institutional investors or hedge funds, whose interests are not necessarily align with those of other shareholders,[113] could take advantage of their increased voting power to extract private benefit to themselves[114] or to promote short-term goals at the expense of long-term value creation activities.[115]

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majority provisions (69.5%); right to call special meeting (51%) and proxy access proposals with 3%- and 3-year thresholds (44%-65%). Sullivan & Cromwell LLP memorandum, *supra* note 23.

[112] *See* Georgeson Report*, supra* note 110*,* at 14.

[113] *See, e.g.*, Kahan & Rock, *supra* note 6, at 1048–57, 1070-79 (discussing the conflict of interests of institutional investors and hedge funds).

[114] *See, e.g.,* Morrison & Foerster LLP, *"Greenmail" Makes a Comeback* (Dec. 20, 2013), available at, http://media.mofo.com/files/Uploads/Images/131217-Greenmail.pdf (arguing that hedge

This argument, however, is also not strong enough to oppose our proposed solution. First, the design of the applicable nudges and default arrangements could be structured to leave the choice of retail investors undisclosed to the rest of the investors, preventing them from acting *ex-ante* based on the assumption that they would have the support of other investors.

In addition, a potential default arrangement could allow shareholders to exercise their vote in accordance with the majority vote of all investors not affiliated with management, that is in accordance with the majority of the "floating vote". This shortcut aligns the interest of retail investors with the majority of shareholders unaffiliated with management, but not with a specific shareholder, and therefore does not negatively affect the decision making of a specific investor.

Finally, the voting nudge could be designed so that each shareholder will have to actively exercise its votes by choosing one of the shortcuts prior to each vote, instead of making an active choose in the first time it has to vote and then having an automatic votes in the next annual meetings based on the initial preferences. Forcing shareholders to make an active choice before each meeting is likely to deter self-interested behavior by dominant shareholders as they will have to regain the trust of other investors prior to each election.

In sum, we believe that none of these objections, either individually or in the aggregate, are strong enough to reject our proposed solution.

VII. CONCLUSION

It is hard to find a corporate law textbook that does not mention the problem of investors' rational apathy in the public firm. This long-standing problem that corporate law scholars have taken as a given for so many years is considered a necessary evil once ownership is no longer closely held. In this Article, we present a behavioral economics solution that could substantially reduce costs of participation to retail investors and limit, if not fully eliminate, the problem of investors' rational apathy

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funds could act opportunistically and extract outsized returns for themselves at the expense of other investors).

[115] *See, e.g.,* Bill George, *Activists Seek Short-Term Gain, Not Long-Term Value*, N.Y. TIMES: DEALBOOK (Aug. 26, 2013, 10:56 am); Ira M. Millstein, *Re-examining Board Priorities in an Era of Activism*, N.Y. TIMES: DEALBOOK (Mar. 8, 2013, 03:52 pm).

with minimal regulatory burden. This novel solution is based on the premise that the economic and mental costs associated with voting could be reduced dramatically by nudging retail investors with highly-visible voting default arrangements. Such nudge would allow (or force) investors to choose between several available voting options, and is likely to substantially increase retail investors' participation in the governance of the firm. Aside from strengthening shareholder democracy, mobilizing retail investors with different voting heuristics will have other important advantages such as providing for greater accountability of the directors of public companies.

Behavioral economics has become the new hope. Regulators are making increasing use of different heuristics to increase our protection as consumers, to encourage us to save for pension, to eat healthier, to protect the environment and so on. Surprisingly, there have been very few applications of behavioral economics to corporate governance, and in particular to the way we, as individual investors, participate in the governance of public firms. This Paper provides the first comprehensive framework as to how it could be done.